BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Petition of WorldCom, Inc., Pursuant to Section	)	
252(e)(5) of the Communications Act for Preemption of	)	CC Docket No. 00-218
the Jurisdiction of the Virginia Corporation Commission	)	
Regarding Interconnection Disputes with Verizon	)	
Virginia, Inc., and for Expedited Arbitration	)	
In the Matter of	)	
	)	
Petition of AT&T Communications of Virginia, Inc.,	)	
Pursuant to Section 252(e)(5) of the Communications	)	CC Docket No. 00-251
Act for Preemption of the Jurisdiction of the Virginia	)	
Corporation Commission Regarding Interconnection	)	
Disputes with Verizon Virginia, Inc.	)	

REPLY OF AT&T COMMUNICATIONS OF VIRGINIA LLC TO OPPOSITION OF VERIZON VIRGINIA INC. TO APPLICATION FOR REVIEW

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REPLY OF AT&T COMMUNICATIONS OF VIRGINIA LLC
TO OPPOSITION OF VERIZON VIRGINIA INC.
TO APPLICATION FOR REVIEW

AT&T Communications of Virginia, LLC ("AT&T") respectfully replies to the October 14 Opposition of Verizon Virginia Inc. ("Verizon") to AT&T's application for review of the Memorandum Opinion and Order adopted by the Commission's Wireline Competition Bureau on August 28 and released by the Commission on August 29, 2003. Memorandum Opinion and Order, DA 03-2738 ("Order" or "Bureau Order"). AT&T seeks review of three aspects of the Order: (1) its cost of capital findings (*id*., ¶¶ 58-104); (2) its treatment of special access line counts in determining line counts and loop costs (*id.* ¶¶ 200-213); and (3) its failure to adjust loop costs to reflect the new limitations on the unbundling obligations of incumbent LECs under the *Triennial Review Order*.

INTRODUCTION AND SUMMARY

Verizon's Opposition merely confirms the lack of reasoned support for the Bureau findings from which AT&T seeks review.[1]

(1) The 12.95 percent cost of capital adopted in the Order is grossly in excess of forward-looking levels. The Commission's newly issued cost of capital standard is reviewable here under 47 C.F.R. § 1.115(b)(2)(i) and (iii). Verizon's comparisons with AT&T and WorldCom's *internal* cost estimates are meaningless: AT&T and WorldCom are fringe players with only tiny market shares in local markets, and the two CLECs' internal cost of capital is far in excess of Verizon's. Nothing in the TELRIC standard requires, or even permits, the legal fiction that Verizon, the incumbent LEC, faces more risk than it actually foresees. Even assuming *arguendo* that the cost of capital must reflect the competitive assumptions of TELRIC, those assumptions are those of a contestable market, not an atomistically competitive one. As the precedent under the stand-alone cost test of the Surface Transportation Board ("STB") makes clear, the contestable market model does not dictate a high cost of capital. And Verizon's attempt to inflate the cost of capital standard *further* to compensate for regulatory risks is foreclosed by the *Triennial Review Order*.

Even assuming that the Commission's new phantom risk standard is sound, the Bureau Order has misapplied it. The Bureau erred in discarding the equity cost estimates produced by the three-stage DCF model. The Order ignored substantial evidence that the 1926-1999 historical risk premiums offered by Verizon overstate forward-looking risk premiums. The Order erred in adopting a short-run market capital structure, rather than a long run *target*

[1] Verizon's assertion that the rates set by the Order are not unreasonably high because they are "marginally higher than the previous Virginia statewide average rate" and remain below the New York benchmark," and because Verizon's Virginia switching rates are the lowest in 31 Verizon jurisdictions" (Verizon Opp. at 1) is essentially a reprise of Verizon's claim, in its Application for Review, that the Bureau rates, judged by these benchmarks, are unreasonably low. AT&T and WorldCom responded to those arguments in the carriers' October 14 joint opposition. AT&T incorporates that response by reference here.

structure. And the Bureau erred in updating the record to reflect the Commission's recent adoption of the phantom risk standard without also considering the dramatic and offsetting decline in the inputs to the cost of capital during the same period.

(2) The Bureau further overstated loop costs by excluding special access lines from the determination of two-wire loop rates. The effect of this procedure is to allocate to ordinary copper pair (DS-0) loops "all of the joint facilities costs of all outside plant"—including costs associated with private and special access lines. This allocation is patently unreasonable under Paragraph 682 of the *Local Competition Order*, and would guarantee, as an arithmetic certainty, that Verizon will overrecover the costs of its joint facilities from ratepayers as a whole.

(3) The Commission's recent abrogation of the unbundling requirements for broadband loops means that the loop rates established by the Bureau are even more excessive. Failure to adjust the loop rates and costs to reflect the limited loop functionalities now available for unbundling to CLECs would result in cross-subsidy of broadband services by narrowband services, an outcome that the Commission itself has recognized would be unlawful. This issue cannot be ducked on the theory that the Commission will address the cost implications of the *Triennial Review Order* in the forthcoming TELRIC rulemaking. The issue is squarely raised here, and must be resolved here.

ARGUMENT

I. THE BUREAU ERRED IN ADOPTING A COST OF CAPITAL OF 12.95 PERCENT.

A. The Commission Should Return To A Cost Of Capital Standard Based On The Competitive Risks Foreseeably Facing Verizon, Not The Phantom Risks Of A Hypothetical Competitive Market.

As AT&T explained in its Application for Review, the phantom risk standard adopted by the Commission in its *Triennial Review Order*, and purportedly applied in the August 29 Opinion, is an arbitrary and unjustified departure from the business risk standard adhered to by

the Commission, state commissions, and reviewing courts since the 1996 *Local Competition Order*. AT&T Application at 3-6. Verizon's Opposition merely confirms this conclusion.

(1) Verizon argues that the Commission's new cost of capital risk standard cannot be challenged on review of the Bureau Order because the standard was established by the Commission in the *Triennial Review Order*, and the Bureau thus was bound to apply it. Verizon Opp. at 5-6. Conflict with "established Commission policy," 47 C.F.R. § 1.115(b)(2)(i), is not the only ground for review of action taken pursuant to delegated authority, however. A party may also seek review of Bureau action on the grounds that "is in conflict with statute, regulation [or] case precedent," or "involves application of a precedent or policy which should be overturned or revised." *Id*., §§ § 1.115(b)(2)(i), (iii). Hence, the issue is properly raised here.

(2) Verizon asserts that the "internal cost of capital figures" used by AT&T and WorldCom "for evaluating investments" demonstrate that the 12.95 percent cost of capital adopted by the Bureau is reasonable even in light of the actual competitive risks of the industry. Verizon Opp. at 3-4. The comparison is meaningless. The risks of AT&T and WorldCom's local businesses are far higher than the risks of Verizon's wholesale UNE business, and one should expect the CLECs' internal cost of capital to exceed Verizon's. Verizon has both a ubiquitous network and a near-monopoly market share in virtually all of its local markets; AT&T is a fringe player with only a tiny toehold in most markets. *See* Response of AT&T to Staff Record Requests Concerning AT&T Internal Cost of Capital (filed Dec. 12, 2001). Moreover, Verizon's "existing infrastructure enables it to serve new customers at a much lower incremental cost than a facilities-based entrant that must install its own switches, trunking and loops to serve its customers." *Local Competition Order* ¶ 10. The rout of the CLEC sector by Verizon and its peers during the past few years underscores the disparity between the business prospects, risks and capital costs of the two kinds of local telephone businesses.

Far more to the point are the internal cost of capital estimates developed for local exchange carriers by investment analysts, and by one of Verizon's peers, Ameritech, for its own investment decisions. *Those* estimates support a cost of capital in the range of 10 percent or less. AT&T/WCOM Ex. 17 (Hirshleifer Surreb.) at 73-74.

(3) Verizon still offers no coherent reason why consistency with the TELRIC standard requires the legal fiction that Verizon, the incumbent LEC, faces phantom risks above the risks it actually faces, and incurs phantom capital costs above the costs that it actually incurs. AT&T Application at 4-5. It is a bedrock principle that the goal of public utility rate regulation is to replicate the performance of effective competition, but it is equally well established that the relevant cost of capital for this purpose reflects the risks and other market conditions that the incumbent actually anticipates. Even Dr. William Taylor, an economic witness for Verizon in many of the UNE cases in Verizon's region since 1996, has acknowledged this distinction. Testifying in the UNE proceeding in Virginia in 1997, Dr. Taylor dismissed the notion that forward-looking pricing methodologies require a departure from the traditional approach of determining the cost of capital in light of the *actual* competitive risks of the regulated enterprise. Dr. Taylor conceded that "it is not unheard of for regulators to set prices in noncompetitive markets that replicate the prices that would result from a competitive market." Moreover, he conceded, "it is possible for a regulatory standard which sets rates at competitive levels to coexist with an environment in which *the regulated firm faces less competitive risks than a competitive firm would face. . .*"[2]

[2] AT&T/WCOM Exh. 10 (Hirshleifer Reb.) at p. 58 (quoting *Ex Parte to Determine Prices Bell Atlantic—Virginia, Inc. Is Authorized to Charge Competing Local Exchange Carriers in Accordance with the Telecommunications Act of 1996 and Applicable State Law, Virginia State Corporation Commission*, Case No. PUC970005, Tr. (11/29/00) 580-81 (Taylor) (emphasis added)).

The United States District Court in Delaware emphasized the same point in rejecting the Verizon's arguments for a cost of capital based on phantom competitive risks:

> Bell points to an apparent contradiction in assuming instantly competitive prices for network elements (even though no such competition now exists) but, in the context of determining cost of capital, assuming little competition and, consequently, low costs of capital. . . . The Telecommunications Act attempts to recreate the prices that a hypothetical efficient company would charge for its network elements and services in a competitive market. Indulging in this fiction, however, does not change the fact that ILECs like Bell do not face the same competitive risks as firms operating in a competitive market. Indeed, ILECs have had no competition for decades, and they will face little competition in the market for network elements in the near future. *See Local Competition Order* ¶ 702, at 353. Therefore, in introducing competition in the local telephone market, it makes perfect sense to recreate competitive prices while acknowledging that the current lack of competition warrants reduced costs of capital.

Bell Atlantic-Delaware, Inc. v. McMahon, 80 F.Supp.2d 218 (D. Del. 2000) at 240 n. 19 (citation omitted) (emphasis added). AT&T has repeatedly cited *McMahon* throughout this proceeding. *See*., *e.g*., AT&T Application at 5. Verizon, in its Opposition, does not mention *McMahon* at all.

Verizon tries to distinguish *Bluefield Waters Works Improvement Co. v. PSC*, 262 U.S. 679, 692-93 (1923), and *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), on the theory that Verizon, as the suppliers of UNEs, faces greater risk than the regulated firms at issue in *Bluefield* and *Hope*. *Cf*. AT&T Application at 5; Verizon Opp. at 8. Whatever risk Verizon actually faces, this is a distinction without a difference. Nothing in *Bluefield* or *Hope* suggests that the "corresponding risk" standard of those cases applies only when the risk is low. And neither decision suggests that the term "corresponding risk," as used by the Supreme Court, was intended to authorize any markup over the returns needed to compensate the regulated firm for its actual risk, whether high or low. To the contrary, the Supreme Court has made clear that the relevant inquiry involves a highly fact-specific scrutiny of the competition, risks and market conditions that the incumbent firm actually faces. *Hope*, 320 U.S. at 604-05. This exercise

would be pointless if, as Verizon contends, the benchmark for assessing risk were the legal fiction of a hypothetical competitive firm. As Verizon's cost of capital witness conceded, under the hypothetical risk benchmark proposed by Verizon, "the parties and the Commission are "wasting our time" by "litigating over what competition Verizon actually faces." Tr. 3479 (Vander Weide).

(4) Even assuming *arguendo* that the cost of capital can properly reflect a hypothetical state of competition, Verizon, like the Bureau, never explains why the appropriate competitive paradigm would justify a cost of capital as high as 12.95 percent. AT&T Application at 5-6. Verizon's insistence that "consistency" with the competitive assumptions of the TELRIC model requires this result (Verizon Opp. at 7 & n. 8) simply begs the question.

"Competition" is not a point, but a continuum. Verizon's own cost of capital witness, Dr. Vander Weide, acknowledged this when asked to specify the level of competition dictated by consistency with the TELRIC standard. The answer, he conceded, could range anywhere from atomistic competition to a duopoly. Tr. 3554-57 (Vander Weide).

Verizon, and the Bureau Order, implicitly assume that the level of competition modeled by TELRIC is close to the textbook model of perfect competition. But this is clearly incorrect. TELRIC does not imply the existence of perfect competition, or even multiple facilities-based competitors. The assumption of multiple facilities-based competitors—or any model approaching the perfectly "competitive market"—might very well imply relatively high risks and capital costs. But it would also require UNE rates set far, far below TELRIC.

Effective competition from multiple facilities-based competitors tends to drive prices down toward marginal cost; and perfect competition results in prices that equal marginal cost exactly. Local telephone networks, however, have large sunk costs and economies of scale and scope. For firms with this cost structure, marginal costs are not only below long run incremental

costs, but are close to zero. Hence, a UNE pricing model that replicated the performance of a perfectly competitive market, or any telephone market with multiple facilities-based competitors, would not remotely compensate even an efficient provider, let alone Verizon, for the cost of the facilities used to provide the UNEs.[3]

Rather, the competitive model underlying TELRIC is not perfect (or near-perfect) competition, but perfect contestability, a more general model of competition. As Verizon's cost of capital witness, Dr. Vander Weide, conceded, "one of the assumptions of TELRIC . . . is that the market is perfectly contestable." Tr. 3587. A contestable market is a market in which entry and exit are instantaneous, costless, frictionless, and without sunk costs.[4] In such a market, a single firm can supply the entire market at any one time (thereby fully capturing available economies of scale and scope), but cannot earn any supracompetitive returns without losing its entire market share, instantaneously, to a competitive entrant.[5]

Verizon has studiously avoided discussing the contestable market model in this proceeding, because its implications are unhelpful to Verizon. The competitive risk faced by

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[3] William J. Baumol, John C. Panzar and Robert D. Willig, *Contestable Markets And the Theory of Industry Structure* xiii (rev. ed. 1988) (emphasis added). It is widely recognized that competition in such conditions can be "wasteful." *See*, *e.g.*, Sidney Shapiro & Joseph Tomain, REGULATORY LAW AND POLICY 189-92 (1993). As Professor Kahn has stated, "[w]hen the entire demand can most efficiently be supplied via a single set of telephone poles . . . it becomes inefficient to duplicate them and to have two companies digging up the streets at various times instead of one." Alfred E. Kahn, II THE ECONOMICS OF REGULATION 121-22 (1970). .

[4] Tr. 3624-27 (Hirshleifer); *accord*, *Coal Rate Guidelines—Nationwide*, 1 I.C.C.2d 520, 528-29 (1983), *aff'd*, *Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3rd Cir. 1987). "The notion of contestable markets offers a generalization of the notion of purely competitive markets, a generalization in which fewer assumptions need to be made to obtain the usual efficiency results. Using contestability theory, economists no longer need to assume that efficient outcomes occur only when there are large numbers of actively producing firms . . . *What drives contestability theory is the possibility of costlessly reversible entry*." William J. Baumol, John C. Panzar and Robert D. Willig, *Contestable Markets And the Theory of Industry Structure* xiii (rev. ed. 1988) (emphasis added); *accord*, *Coal Rate Guidelines*, 1 I.C.C.2d at 528.

[5] *Coal Rate Guidelines*, 1 I.C.C.2d at 528-29, 543.

participants in a perfectly contestable market, the market whose performance the TELRIC standard seeks to emulate, would be *lower*, not higher, than the risk that Verizon actually faces going forward. In such a market, a firm that lost some or all of its customers to a new entrant could simply liquidate its investment and immediately exit the market. The risk that competition could strand some or all of the incumbent firm's sunk investment—the biggest business risk that actual firms face in actual markets—would be absent.[6]

The stand-alone cost ("SAC") test, the TELRIC-like cost standard used since 1985 by the Interstate Commerce Commission ("ICC") and its successor, the Surface Transportation Board ("STB"), to regulate rates paid by captive rail shippers, illustrates the practical implications of this logic. AT&T Application at 6 n.7. As implemented by the ICC and the STB, the SAC test combines the forward-looking cost assumptions of perfect contestability with a cost of capital based on the competition and risks that the incumbent carriers actually face. *See id*.; WorldCom Application at 5 n.7 (citing precedent).

Verizon asserts that the SAC precedent is "inapt" because (1) "railroads have not experienced the technological progress found in the telecommunications industry, so the risk created by TELRIC that prices will be driven down due to (assumed) technological progress

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[6] Tr. 3625-26 (Hirshleifer); *accord*, *Coal Rate Guidelines*, 1 I.C.C.2d at 528-29. Even Dr. Vander Weide conceded that "If we assumed . . . that there are no sunk costs, then that would affect the cost of capital." Tr. 3589.

The testimony of AT&T/WCOM witness Terry Murray, whom Verizon selectively quotes for the proposition that "forward-looking cost of capital" used in UNE studies must assume a "competitive market," Verizon Opp. at 7, was consistent with this point. Her actual testimony was that, as a matter of "theory," the competitive assumptions of cost of capital analysis should be "consistent" with the other assumptions of the cost model. Id. at 3202. She emphasized, however, that the actual estimation of a cost of capital in a hypothetical competitive market "is a tricky matter"; that she had not thought "through how one would" make the necessary "theoretical adjustment" to estimate the cost of capital in such a market, and that "Mr. Hirshleifer is the witness who will deal with this." Id. at 3200-01. In all likelihood, she explained, the outcome need not be a "radically high cost of capital." Id. at 3404-06.

does not exist"; and (2) the SAC test is generally applied only to a "single route or group of shippers and therefore does not reflect any economies that would result from building an entire network." Verizon Opp. at 8-9. Hence, Verizon asserts, SAC "is usually *higher* than the incumbent's forward-looking cost, and its application does not create the same regulatory risks as TELRIC." *Id.* Each of these claims is false.

First, since 1980 the railroad industry has experienced some of the highest productivity growth rates of any major industry in the United States. From 1980 to 2001, rail labor productivity rose 360 percent, locomotive productivity rose 132 percent, track productivity rose 138 percent, and fuel productivity rose 71 percent. Overall, revenue ton-miles of freight per constant dollar operating expense rose 182 percent from 1981 to 2001.[7] These cost savings have been passed through to rail customers. From 1981 to 2002, average rail rates fell 29 percent in current dollars and *60 percent* after adjusting for inflation.[8]

Second, the ICC and the STB have expressly authorized shippers in rate cases to design SAC models that encompass multiple routes and shipper groups. The two agencies have done so for the very reason alluded to by Verizon: grouping routes, shippers and traffic "permits the complaining shipper to 'take full advantage of any economies of scale, scope and density' associated with shared facilities by spreading the joint and common costs among a larger traffic base."[9] "The ability to group traffic of different shippers is essential to [the] theory of contestability. It allows the captive shipper to identify areas where production economies define

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[7] Association of American Railroads, *Railroad Productivity* (Jan. 2003) at 1.

[8] Association of American Railroads, *Falling Railroad Rates: Billions of Dollars in Shipper Savings* (July 2003) at 1; *accord*, Surface Transportation Board Office of Economics, Environmental Analysis, and Administration, *Rail Rates Continue Multi-Year Decline* (Dec. 2000) at 1 (railroads rates fell by 45 percent from 1984 to 1999, after adjusting for inflation).

[9] *PPL Montana, LLC v. Burlington N. & S.F. Ry.*, STB Docket No. 42054 (served Aug. 20, 2002), slip op. at 6 (quoting *Coal Rate Guidelines*, *supra*, 1 I.C.C.2d at 532); *Coal Rate Guidelines*, 1 I.C.C.2d at 542-44.

an efficient subsystem or alternative system whose traffic is divertible to a hypothetical competitor." *Coal Rate Guidelines*, *supra*, 1 I.C.C.2d at 544. For these and other reasons, the resulting SAC estimates are almost always lower, not higher, than the incumbent railroads' current costs. "If the current carrier is fully efficient and realizes economies of scale, scope and density, its existing configuration will yield the lowest overall cost of service. If not, a captive shipper can have its rates based on the *lower* costs of an alternative, 'stand-alone' system in which *plant size and traffic base are designed to maximize the efficiencies and production economies."*[10]

(5) Verizon's contention that the "TELRIC cost of capital" must be inflated even further to compensate for "regulatory risks" (Verizon Opp. at 4-5, 9) was waived by Verizon in the proceeding below; is refuted by even the economic literature cited by Verizon; and is foreclosed by the Commission's disposition of the issue in ¶ 683 of the *Triennial Review Order*. These issues were addressed in the WorldCom and AT&T's Opposition to Verizon Motion for Stay and Application for Review ("AT&T/WorldCom Opp. to Verizon Application") at pages 21-25, which we incorporate by reference and do not repeat here. Verizon's continued misuse of

[10] *Coal Rate Guidelines*, *supra*, 1 I.C.C.2d at 542 (emphasis added). Verizon cites a recent monograph by Alfred Kahn, in which he asserts that the SAC ceiling cannot prevent recovery of "the actual LRIC or TSLRIC of the railroads" because the STB has no authority to set maximum rates below 180 percent of variable costs, a threshold that Dr. Kahn asserts assures recovery of those costs. Verizon Opp. at 9 n.9 (citing Kahn, *Whom the Gods Would Destroy, or How Not To Deregulate* (2001) at 61-62 n. 40). Dr. Kahn is mistaken. The measure of variable cost used for the purpose is the variable cost of an *individual* freight shipment, and thus (unlike the TELRIC standard) excludes costs incurred jointly or in common by multiple shipments or routes. *Coal Rate Guidelines*, 1 I.C.C.2d at 526 & n. 11. Because most rail traffic faces too much competition for the railroads to charge rates much above variable cost, most of the industry's joint and common costs must be recovered from a relatively small body of relatively inelastic traffic. Limiting all railroad rates to 180 percent of variable costs would spell bankruptcy for the industry. *Coal Rate Guidelines*, 1 I.C.C.2d at 523, 531 & n. 29. Hence, the forward-looking SAC test is very much a binding constraint on railroad rates and earnings.

footnote 8 to the Commission's reply brief to the Supreme Court in *Verizon Communications*, however, should not pass unchallenged. *Cf.* Opposition at 4 & 10.

Verizon cites only the following excerpt: "an appropriate cost of capital determination takes into account not only existing competitive risks . . . but also risks associated with the regulatory regime to which a firm is subject." *Id*. The footnote actually reads as follows:

> Moreover, an appropriate cost of capital determination takes into account not only existing competitive risks, as the FCC recently recognized (see Local Competition Order (para. 702), J.A. 395-396), but also risks associated with the regulatory regime to which a firm is subject. *That second consideration is, notwithstanding the incumbents' contrary suggestion (BellSouth Resp. Br. 30-32), implicit in any determination of the true economic cost of capital.* See generally *Represcribing the Authorized Rate of Return for Interstate Servs. of Local Exch. Carriers,* 5 F.C.C.R. 7007, 7521 (1990) (para. 120) ["*1990 Rate Represcription*"], aff'd sub nom. *Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254 (D.C. Cir. 1993).

Reply Brief for Petitioners United States and the FCC, *Verizon Communications, Inc. v. FCC*, No. 00-511 *et al.,* at *12 n.8 (July 2001) (emphasis added).

The portions omitted by Verizon are telling. The discussion of regulatory risk in the italicized portion of the footnote ("risks associated with the regulatory regime to which a firm is subject") is clearly a *rejection* of the additive for "regulatory risk" that Verizon proposes here: compensation for the "risks associated with the regulatory regime to which a firm is subject" is "implicit in *any* determination of the true economic cost of capital"—"*notwithstanding the incumbents' contrary suggestion.*" FCC Reply Br. at 12 n. 8 (emphasis added).

The citation at the end of footnote 8 to the *1990 Rate Represcription* proceeding eliminates any possible doubt on this point. In the 1990 proceeding, the Commission specifically rejected the incumbent LECs' arguments for an additive to the cost of capital (rate of return) to compensate for the risk that the Commission (or any other regulatory agency) might exclude prudent investments from a carrier's rate base. In declining to approve any such adjustment, the Commission explained:

> Nothing in the Constitution or in the Communications Act requires the agency to adjust the prescribed rate of return to take into account *the agency's policies regarding rate base disallowances.* Rather, the methodologies we employ to determine the appropriate rate of return already take into account *the FCC's approach to such disallowances.* Investors are presumably aware of our ratemaking procedures, including our treatment of plant that is not automatically included in the rate base, and take these procedures into account in establishing the price of the stock. *The risk of disallowance, including the disallowance of prudent investment, is one of many factors that investors consider in evaluating the riskiness of investment in a regulated enterprise. Thus, the rate of return prescription itself already takes into account the fact that the FCC generally disallows prudent investments that are not "used and useful" in providing service.*

1990 Rate Represcription, 5 FCC Rcd. at 7521 (¶ 120) (emphasis added). The U.S. Court of Appeals for the D.C. Circuit, affirming the Commission, recognized that the Commission had held only "that because investors are aware of its rate base policies, the agency's market-based methodologies for determining the rate of return will produce a rate high enough to compensate for that risk." *Illinois Bell Tel. Co. v. FCC,* 988 F.2d at 1263.

The Commission's logic applies with equal force here. The Commission and state commissions have set UNE prices under the rubric of the *Local Competition Order*—and, in general, rejected the inflated cost of capital measures proposed by Dr. Vander Weide—for seven years. The nature of these standards has been no secret to the industry and its investors. *See* Tr. 3525-27 (state commissions have been sending "price signals" to potential entrants by setting purportedly TELRIC-compliant prices for UNEs since 1996). Whatever regulatory risks the TELRIC standards may create should be fully reflected in the returns demanded by investors, and no return additive for regulatory risk is warranted.

(6) Finally, Verizon fails to reconcile the phantom risk cost of capital standard with Section 252(d)(1)(A)(ii) of the 1996 Act, which bars undue discrimination in the pricing of UNEs. AT&T Application at 5. Verizon's first argument, that an appropriate cost of capital "must take into account future competitive risks" (Verizon Opp. at 9), completely misses the

point. The issue here is *not* whether the cost of capital should reflect the competitive risk, high or low, actually anticipated by investors from cable telephony, VOIP, or other new modes of communication: those risks, to the extent regarded as material by investors, are already reflected in current securities prices. The issue is whether the cost of capital should include an *additional* markup *above* the return needed to compensate investors for the competitive risks, large or small, that Verizon's investors actually anticipate. And Verizon's fallback argument, "regulatory risk," is unsound for the reasons explained above.

B. Even Assuming *Arguendo* That The Commission's Phantom Risk Standard Is Sound, The Order Has Misapplied It.

1. The Bureau erred in discarding the equity cost estimates produced by the three-stage Discounted Cash Flow ("DCF") model.

The welter of arguments and assertions offered by Verizon concerning the choice of DCF model issue cannot change reality. Multistage DCF models, including the three-stage DCF model used by AT&T/WCOM witness Hirshleifer, have gained widespread acceptance among economists and securities analysts. The one-stage model offered by Verizon has been overwhelmingly rejected. *Cf*. AT&T Application at 7-8 (citing record); Verizon Opp. at 12-15.

Verizon parrots the Bureau's finding that AT&T and WorldCom offered "no explanation or evidence supporting the magnitude or the pattern of the growth rate assumptions beyond the fifth year." Verizon Opp. at 13 (citing *Order* ¶ 75). The record speaks for itself. AT&T and WorldCom showed that (1) the "magnitude" and "pattern" of the growth rate assumptions are reasonable models of the inevitable regression of above-average short run rates of earnings growth to the long run growth rate of the economy; (2) the specific values used by Mr. Hirshleifer are widely accepted among economists and financial analysts; and (3) commonly used alternative multi-stage growth rate assumptions would produce comparable—or even lower—equity cost estimates. AT&T Application at 8 (citing record); Tr. 3671-72 (Hirshleifer).

And Ibbotson Associates, which Verizon has invoked as a "well-known and well-accepted" authority (Opp. at 15-16 & n. 15), has explained that a three-stage DCF model

> fits with life cycle theories in regards to company growth. In these theories, companies are assumed to have a life cycle with varying growth characteristics. Typically, the potential for extraordinary growth in the near term eases over time and eventually growth slows to a more stable level.

SBBI/Ibbotson Associates, *Valuation Edition 2003 Yearbook* at 62. Instead of analysis, Verizon responds with empty name-calling. Verizon Opp. at 13 (deriding the multi-stage approach as an "arbitrary" and "simply self-serving" "patchwork" of "different assumed growth rates").

Verizon asserts that AT&T "identified no specific error" in an analysis by Verizon's cost of capital witness, Dr. Vander Weide, purportedly showing that the three-stage DCF model has the paradoxical result of imputing a higher equity cost to lower risk companies. Verizon Opp. at 12-13 (citing Order ¶ 76). In fact, AT&T and WorldCom's cost of capital witness identified not one, but several specific errors in Dr. Vander Weide's analysis. For example:

- Dr. Vander Weide failed to exclude companies that pay no dividends or small dividends from his DCF sample. Including such companies has been demonstrated to produce biased results.

- Dr. Vander Weide limited his samples to as few as three companies, even though (1) he could have readily drawn a much larger sample, and (2) he has testified that a sample of even four to five companies is too small to yield an accurate estimate of a group's cost of capital.

- Dr. Vander Weide included in his group of "electric" companies (which he offered as an example of a low-risk business) firms with significant exposure to the electricity, gas, nuclear energy, international and other relatively high risk markets. Indeed, several of the companies in his "low risk" group have gone bankrupt, or are in financial distress.

AT&T/WCOM Exh. 17 (Hirshleifer Surreb.) at 77-78. AT&T/WCOM specifically cited these criticisms in their Initial Cost Brief (at 67-68 & nn. 58-59), and again in their Reply Brief (at 17). AT&T cited the same criticisms a third time in its Application for Review (at 9). The Bureau never responded to these criticisms, or even acknowledged their existence. *Order* ¶ 76. Neither

has Verizon.

Verizon's reliance on Dr. Vander Weide's purported showing that the "average growth rate in" the three-stage DCF model has no correlation with the "companies' price-to-earnings ratio" is equally meretricious. Verizon Opp. at 14 (citing Verizon Exh. 192). In response to this exhibit, AT&T and WorldCom identified, *inter alia*, the following errors in his analysis:

- None of Verizon's new regressions tested the three-stage growth model actually used by Mr. Hirshleifer. Mr. Hirshleifer's model uses 17 growth terms, and a regression analysis that tested these growth assumptions would require at least 17 distinct independent variables for growth. Instead of using the separate variable needed to capture the year-by-year cross-sectional growth values, however, Verizon conflated them into a single perpetual growth variable that purported to reflect the "average" of the 17 growth terms. Thus, Dr. Vander Weide was simply comparing two perpetual growth models, neither of which was a legitimate proxy for Mr. Hirshleifer's three-stage model.

- Verizon's regression analysis used linear function forms, which assume that changes in the dependent variable cause the dependent variable to change at a constant rate. But the growth assumptions of multi-stage growth models are non-linear. The negative correlation observed by Verizon between its "three-stage growth" variable and Value Line P/E ratios is typical of the bizarre results that often result from using a linear function to explain nonlinear economic relationships.

- Verizon's regression analysis was also tainted by the inclusion of companies that paid no dividends or low dividends.

- The conclusions drawn by Verizon from the regressions were contradicted by the economic literature cited by Dr. Vander Weide himself.

Objections of AT&T and WorldCom to Verizon Response to Staff Record Request For Literature Comparing the Accuracy of One-Stage vs. Multi-Stage DCF Models (Dec. 18, 2001). Verizon has never offered any response to these criticisms either.

Finally, Verizon's belated challenge to the Bureau's decision to reject the one-stage DCF (Verizon Opp. at 14-15) cannot be taken seriously. Verizon did not raise this issue in its Application for Review (*see* Verizon Application at 49-51). In any event, Verizon's assertion that companies may commonly "grow at rates much greater than that of the GNP for long

periods" (Verizon Opp. at 13) does not begin to justify a one stage DCF, which assumes that *all* companies in the DCF comparison group, on average, will sustain such above-normal growth for many years. AT&T/WCOM Post-Hearing Br. at 62 (citing record). No large and diverse group of companies has ever managed to accomplish this feat. Dr. Vander Weide could not identify a single exception to this unbroken record; and he ultimately disavowed any claim that the companies in his DCF comparison group "are likely to grow at an above-average rate for a long period of time." *Id*. at 62-63; Tr. 3448-49, 3543.

Verizon's assertion that error created by the one-stage growth assumption is trivial because "the results of future periods are discounted in the DCF model" (Verizon Opp. at 15) is also refuted by the record. Because earnings growth projections are compounded from year to year, the error created by the constant growth assumption is significant, even decades into the future. AT&T/WCOM Post-Hearing Br. at 63-64 (citing record). Even Dr. Vander Weide has admitted that the choice between the one-stage and three-stage DCF models accounts for a difference of approximately 200 basis points (i.e., two percentage points) in the cost of equity. *Id*. at 64.

2. The Order ignored substantial evidence that the 1926-1999 historical risk premium data offered by Verizon overstate the forward-looking risk premium.

Verizon also fails to muster any credible reason for relying on historical risk premium data from 1926-1999 rather than forward-looking risk premiums. AT&T Application at 9-10; Verizon Opp. at 15-18.

Verizon brushes off Professor Ibbotson's recent research, which shows that forward-looking risk premiums are now well below the 1926-1999 historical average, on the ground that he was referring to the expected geometric mean of return on stocks, not the arithmetic mean. Verizon Opp. at 16 n. 15. In an article earlier this year, however, Professor Ibbotson found that

even the long term *arithmetic* forward-looking equity risk premium is only in the range of six percent—approximately two percentage points below the 8.10 percent long term premium adopted in the *Order*.[11] He also acknowledged that other recent academic research has obtained significantly lower values.[12]

Verizon dismisses the latter research as a "few select academic articles" that AT&T "never referred to . . . in the course of this proceeding," thereby depriving the Commission of any "basis on the record to evaluate the assumptions underlying the papers." Verizon Opp. at 16-17 n. 15. In fact, AT&T/WorldCom witness Hirshleifer cited this literature prominently in his direct and surrebuttal testimony and on the witness stand. The distinguished scholars and practitioners cited by Mr. Hirshleifer included John Bogle, Jeremy Siegel, Alfred Rapaport, Michael Mauboussin, Eugene Fama, Jay Ritter, James K. Glassman and Kevin A. Hassett. Their research shows that equity risk premiums are now well below historical levels, and may now be as low as *one percent*. AT&T/WCOM Exh. 5 (Hirshleifer Dir.) at 30-31 (citing recent literature); AT&T/WCOM Exh. 17 (Hirshleifer Surreb.) at 44-46 (citing recent literature). And a survey performed by two of Dr. Vander Weide's colleagues at Duke University found that "the average equity risk premium that [corporate] CFOs were using was between 3.6 and 4.7 percent." Tr. 3643 (Hirshleifer). Verizon's failure to challenge this evidence was not for lack of adequate notice.

Verizon's dismissal of the 10.20 percent market rate of return projected by Merrill Lynch as "unsupported" (Verizon Opp. at 17) is equally unfounded. Mr. Hirshleifer explained in his direct testimony that he had validated the Merrill Lynch analysis by comparing its results with the results of his own three-stage DCF analysis for data approximately two years earlier.

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[11] *Cf*. Roger C. Ibbotson and Peng Chen, "Stock Market Returns in the Long Run: Participating in the Real Economy," 59 *Financial Analysts' J.* (Jan./Feb. 2003); *Order* ¶ 86.

[12] *Id*.

AT&T/WCOM Exh. 5 (Hirshleifer Dir.) at 28. Verizon's objection that the earlier analysis is "irrelevant" because "what Mr. Hirshleifer may or may not have done in previous UNE cases is not on the record here and is clearly irrelevant" (Verizon Opp. at 17) is disingenuous. Mr. Hirshleifer put Verizon on notice in his direct testimony that he was relying here on his prior analysis. AT&T/WCOM Exh. 5 at 28. If Verizon had any questions about the earlier calculations, Verizon was free to seek answers through discovery. Moreover, and in any event, Dr. Vander Weide, by performing a similar validation exercise, obtained *lower* risk premiums than did Mr. Hirshleifer. AT&T Application at 11 (discussing VZ Exh. 112 (Vander Weide Reb.) at 52); AT&T/WCOM Exh. 17 (Hirshleifer Surreb.) at 48-49.[13]

3. The Order erred in adopting a short-run market capital structure rather than a long-run target market capital structure.

Verizon's defense of the 80/20 equity/debt ratio adopted by the *Order* evades the issue raised by AT&T: that a market value capital structure based on current equity prices overstates the equity weighting found in the economically relevant capital structure: the *target* capital structure that an efficient firm would seek over the long run. AT&T Application at 11-12; Verizon Opp. at 11-12.

Verizon's assertion that Mr. Hirshleifer supported the same 80/20 "market-based capital structure" adopted by the Bureau (Verizon Opp. at 11) is inaccurate. Mr. Hirshleifer's testimony was that the relevant "market-based capital structure" could not be observed directly, was likely to be considerably lower than the upper bound of 80 percent indicated by Verizon's current

[13] Verizon's rejoinder that Dr. Vander Weide disclaimed support for the three-stage DCF model used by both witnesses for this validation exercise (Verizon Opp. at 17-18) misses the point. Dr. Vander Weide's exercise demonstrates that, as a matter of arithmetic, Mr. Hirshleifer's three-stage DCF methodology produces forward-looking risk premiums comparable to those obtained by Merrill Lynch. The *conceptual* soundness of the three-stage DCF methodology is supported by other evidence of the record, and does not need Dr. Vander Weide's blessing.

market weighting, and was best estimated as the average of the book and market capital structure of Verizon's publicly traded parent. AT&T/WCOM Exh. 5 (Hirshleifer Dir.) at 37; AT&T/WCOM Exh. 17 (Hirshleifer Surreb.) at 53.

4. The Bureau's selective updating of the record was arbitrary and capricious.

Verizon's Opposition also confirms that the *Order* erred in selectively adopting the phantom risk theory that Verizon and other incumbent LECs successfully lobbied the Commission to adopt after the record closed two years ago, but making no effort to update the cost of capital data submitted by the parties to reflect the dramatic (and offsetting) decline in the inputs to the cost of capital during the same period. AT&T Application at 12-13.

Verizon's rejoinder—that the Commission's "clarification" of the relevant risk standard in its *Triennial Review Order* was not a "new piece of factual evidence or a novel legal argument" (Opposition at 6-7)—indulges in semantics. The cost of capital standard established in Paragraph 702 of the *Local Competition Order* focused on the degree of risk that the incumbent LECs "face," and the reality that UNEs "generally are bottleneck, monopoly services that do not now face significant competition." *Id.*, ¶ 702; *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F.Supp.2d at 240 n. 19. The standard adopted in the *Triennial Review Order*, at least as the standard was interpreted by the Bureau in this case, abandoned the requirement that "the Commission should look at the existing level of competition" in favor of a requirement that (1) the cost of capital "must reflect the risks of a market in which Verizon faces facilities-based competition," and (2) the "assumption that Verizon is, and will remain, the dominant local telephone company *cannot* form the basis of our cost of capital decision." *Bureau Order* ¶¶ 62-63. The latter standard is a repudiation, not a clarification, of the former.

II. THE BUREAU FURTHER OVERSTATED LOOP COSTS BY EXCLUDING SPECIAL ACCESS LINES FROM THE DETERMINATION OF TWO-WIRE LOOP RATES.

In its application for review, AT&T demonstrated that the Bureau should have included the special access and high capacity lines in its line count and at a minimum should use the 4.3:1 DS-1/DS-0 and 41.3:1 DS-3/DS-0 ratios in determining line counts to allow the sharing of the economies of scale and scope in the joint structure costs between two-wire and high capacity loops. AT&T Application at 13-19. Verizon concedes, as it did during the hearings,[14] that sharing such economies between the two-wire loop and high capacity lines is appropriate, but claims that such sharing is possible only with Verizon's cost model. This is patently incorrect and simply another version of Verizon's all-out attack on the Modified Synthesis Model ("MSM"). As such, it is no more convincing in this version than in prior renditions. Verizon also claims that the high capacity loops do not overrecover structure costs, but it is clear that fully including the $526 million in joint structure costs in the two-wire loop rate and then including those same structure costs in the high capacity loop rates allows Verizon to overrecover those joint structure costs.

In this proceeding, AT&T sought information from Verizon that would allow the development of the appropriate line counts for use in determining loop costs. Verizon's unwillingness or inability to provide appropriate data to AT&T/WorldCom on non-switched loops (including special access and private line loops) prevented the development of full line count information and forced AT&T/WorldCom to rely on the most reasonable data available from ARMIS reports and other sources. AT&T/WorldCom's approach, including use of the 24:1 DS-1/DS-0 and 672:1 DS-3/DS-0 ratios applied to the *subset* of line count data produced by Verizon, was consistent with the approach used by the Commission in the Synthesis Model used

[14] Tr. 4518 (Gansert); *see* AT&T Application at 15-16.

to determine universal service costs. AT&T Application at 13-14; AT&T/WCOM Ex. 14 (Pitkin Surreb.) at 72-73. If Verizon had provided full line count information, this problem could have been avoided.

Verizon defends itself by claiming that it provided line count information, Verizon Opp. at 20 n.18, but that information was premised on its position that high capacity lines should be counted on a physical line basis, which is inconsistent with the approach taken by AT&T/WorldCom (and the Commission in the universal service fund context**).** As the sole custodian of the information, Verizon was the only party in a position to provide Virginia line count information. Instead of providing full responses (does Verizon not know how many lines it serves in Virginia?), it used that control to parcel out incomplete information based on its litigation position in the case. Having failed to provide full line count information, Verizon should not now benefit by having its view endorsed by this Commission based on that incomplete production of information, and the Bureau should use the best information available on line counts presented in this proceeding by AT&T/WorldCom.

The Bureau decided to exclude the cost of all special access lines in determining the two-wire loop rate due to concern about the use of different ratios in determining total loop costs and cost allocation. As the Bureau acknowledged, this approach shared *none* of the economies resulting from $526 million in shared structure costs with high capacity lines. As a result, the two-wire loop rate bore all such shared structure costs, and these shared structure costs were double-recovered in the rates for high-capacity services. To remedy the Bureau's failure to comply with TELRIC cost allocation principles in excluding the special access lines, *Local Competition Order* ¶ 682, AT&T proposed in its Application for Review that the Commission adopt the 4.3:1 DS-1/DS-0 and 41.3:1 DS-3/DS-0 ratios to determine line counts and total costs to allow the economies to be shared between two-wire and high capacity lines. AT&T

Application at 15-19. This approach results in allocation of $90 million of the $526 million in shared structure costs to high capacity lines and the reduction of two-wire loop investment by $23 per line to $112.73 per line. AT&T Application Exh. 3.

In its opposition, Verizon concedes that the Commission should "allocate the proper share of shared structure cost" to the two-wire and high capacity lines but argues that this can be done only with Verizon's cost model. Verizon Opp. at 18. Verizon describes in detail the various ways in which its models allocate the shared structure costs, *id.,* and claims "that none of [the structure sharing] problems would have arisen had the *Order* adopted Verizon VA's loop and high capacity models." Verizon Opp. at 22. This is yet another iteration of Verizon's argument against the MSM and in favor of its own cost models.

Although the Verizon model did allocate the shared structure costs, as the Bureau determined, it had numerous fundamental deficiencies, and as AT&T showed in its opposition to Verizon's motion for stay and application for review,[15] the Bureau's selection of the MSM for use in computing loop costs reflected a reasoned judgment based on a detailed review of the MSM and the variety of cost models proposed by Verizon. The Bureau appropriately determined that the MSM was consistent with TELRIC principles in providing an estimate of forward looking costs, and was transparent, adjustable, and verifiable, allowing parties to review and change inputs, and develop alternatives based on clearly published formulas and inputs. *Order* ¶¶ 49-53. By contrast, the Bureau found that Verizon's proposed models did not satisfy these criteria in important respects. *Id.* ¶¶ 171-73. For example, Verizon's LCAM model was not a cost model at all but an engineering cost study based on Verizon's embedded network. As a result, it could not determine forward-looking economic costs based on forward-looking network design standards using the most efficient technology. Moreover, questions of

[15] Opposition of WorldCom, Inc. and AT&T Communications of Virginia, LLC to Verizon Virginia Inc.'s Motion for Stay and Application for Review, *passim* (October 14, 2003).

transparency and verifiability affected LCAM and other Verizon cost models, which made it difficult for parties and the Bureau to test assumptions and change inputs. *Id.* ¶¶ 172-73. Given the MSM's compliance with the Bureau's standards for a cost model, and the failure of Verizon's cost models to satisfy those straightforward standards, the Bureau's selection of the MSM to develop loop costs was eminently reasonable.

As it is clear that the parties agree that sharing of economies between two-wire loop and high capacity lines is appropriate, the only issue is whether AT&T's approach appropriately captures those savings.[16] As AT&T demonstrated in its Application for Review, its approach provides for the full cost recovery of the joint structure costs but allows the economies to be shared between the two-wire loop and high capacity lines. AT&T Application at 15-19. Verizon argues that the alleged inability of the MSM to model high capacity loop costs is a shortcoming of the MSM that means that it cannot be used to allocate shared structure costs. Verizon Opp. at 20-21. That is demonstrably incorrect, as the only time there is no sharing of structure costs is when, as here, the Bureau eliminates all special access lines from the determination of total costs. As AT&T's proposal to use the 4.3:1 and 41.3:1 DS-1 and DS-3 ratios demonstrates, including the cost of high capacity lines in the determination of total costs results in a sharing of the joint structure costs: over $90 million in shared structure costs are allocated to high capacity lines. AT&T's Exhibit 3 to its Application for Review shows the sharing of efficiencies and allocation of the shared costs between the two-wire loop and high capacity lines.

[16] Verizon's failure to provide full discovery responses on the line count issue prevented AT&T from raising its proposal during the proceedings. The Bureau, however, retains discretion, in evaluating the parties' compliance filings, to consider as well the TELRIC implications of the failure of its Order to address the sharing of economies of scale and scope between two-wire loops and high capacity lines.

Verizon also argues that the "putative allocation concerns raised by AT&T/WorldCom [are] at best greatly overstated." Verizon Opp. at 21. The overstated position is Verizon's. The amount of shared structures is over half a billion dollars, which is considerable by any measure. Verizon downplays the opportunities for shared structure between two-wire loop and high capacity lines, but Verizon's examples reflect its embedded network mindset and again do not reflect the opportunities for sharing in a forward-looking network, where fiber feeder is used in the local loop to provide eventual service to two-wire loops. Verizon's own cost model shares these available cost savings, and only the Bureau's elimination of the special access lines from the line count prevents a similar sharing of economies under AT&T/WorldCom's MSM. AT&T's proposal in its Application allocates over $90 million to the high capacity lines and results in a reduction of loop investment of $23 per line. Verizon scoffs that this is "only about 4 per cent of the total investment per loop," Verizon Opp. 22 n.19, but it is a significant amount to others, if not to Verizon.

Verizon also argues that the high capacity loops do not overrecover Verizon's structure costs. Verizon Opp. at 23-27. This argument is a warmed-over version of the claims presented in its application for review that the Bureau's high capacity loop rates are not cost-based. This argument has not improved with repetition. As AT&T/WorldCom demonstrated in their opposition to Verizon's application for review (at pages 41-43), the high capacity loop rates are based on cost relationships developed between the two-wire loop rate and the high capacity lines. Although Verizon fails to mention it, the cost relations of 4.3:1 for DS-1/DS-0 and 41.3:1 for DS-3/DS-0 (equivalent to 9.6:1 for DS-3/DS-1) rates are roughly comparable with the cost relationships that Verizon itself developed -- 6.1:1 DS-1/DS-0 and 10:1 DS-3/DS-1 rate relationships. These are clearly similar to cost factors proposed by AT&T and adopted by the Bureau. *Order* ¶ 342. Similarly, the Bureau reviewed evidence from the Access Charge Reform

proceedings that provided similar information on the cost relationship between these lines, *id.*, and indeed, these ratios are comparable to the information provided by Verizon on DS-1 and DS-3 rates in the Verizon territory in its Application for Review.

Verizon's criticism of the use of cost relationships in determining high capacity loop costs is also inconsistent with its approach in its cost models, which make frequent use of such cost relationships to derive UNE rates. For example, to derive the total installed cost associated with DLC equipment, Verizon begins with a material cost assumption and applies an Engineering, Furnished and Installation ("EF&I") factor to develop the total installed costs of DLC. Even though Verizon could readily develop the bottom-up labor increment and labor rates associated with the installation process to derive these costs, the company uses a cost factor. Verizon's cost models contain many other examples of reliance on factors to develop costs, including its reliance on joint and common cost factors and other asset support factors.

Verizon also states that lack of a cost relationship for the high capacity loops means that there can be no claim of cost overrecovery from those high capacity loops. This is incorrect. Under the Bureau's approach, the $526 million in shared structure costs are being recovered totally from the two-wire loop rate, and as a result any recovery of these joint structure costs by the high capacity loops results in a cost overrecovery. As the two-wire loop rate includes the joint structure costs, the use of the cost factors and the inclusion of that joint structure cost in the high capacity loop rate means that Verizon will overrecover its joint structure costs. AT&T Application at 16, 19. The amount of the overrecovery is set forth in Exhibit 1 of the AT&T Application for Review.

Finally, Verizon criticizes AT&T/WorldCom's approach on the ground that use of overall cost ratios do not provide a sufficient basis for allocating particular shared structure costs. Verizon Opp. at 25-26. This argument misstates AT&T's approach. The Bureau was

concerned that use of inconsistent ratios would not allow appropriate cost recovery. The use of the 4.3:1 DS-1/DS-0 and 41.3:1 DS-3/DS-0 ratios is designed to allow the allocation of costs between the two-wire loop and the high capacity lines. This use of ratios permits the determination of costs allocated to high capacity loops while at the same time ensuring that Verizon enjoys *full* cost recovery of the $526 million of shared facilities. It does not seek to, and there is no requirement that it must, address individual pieces of shared structure; this is cost modeling, not engineering, and the allocation of shared structure costs is a cost modeling goal based on the joint use of facilities in a given MSM cluster between two-wire loops and the high-capacity loops in the same MSM cluster. Accordingly, the methodology directly addresses the Bureau's concern of allocating the shared facilities costs between two-wire loop and high capacity lines, as Verizon concedes is appropriate, and results in full cost recovery -- but also no overrecovery of costs -- by Verizon.

III. THE COMMISSION'S ABROGATION OF THE UNBUNDLING REQUIREMENT FOR BROADBAND LOOPS MEANS THAT THE LOOP RATES ESTABLISHED BY THE BUREAU ARE NOW EXCESSIVE.

Verizon offers two excuses for the failure of the Bureau to consider the cost effects of Paragraphs 285-97 of the *Triennial Review Order*, which drastically curtailed the obligation of incumbent LECs to unbundle the broadband capabilities of their loops. *Cf.* AT&T Application at 19-21; Verizon Opp. at 19-21. Neither has merit.

First, Verizon argues that the issue is off limits in this proceeding because the Commission is currently considering the same issue in the TELRIC rulemaking. Verizon Opp. at 28-29. It is "hornbook administrative law," however, that an administrative agency may announce rules and interpretations of rules through *either* adjudication *or* a formal notice-and-comment rulemaking proceeding.[17] Because this case squarely raises the issue of what effect the

[17] *See, e.g., NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 294 (1974); *SEC* v. *Chenery*, 332 U.S. 194, 203 (1947); *Interstate Natural Gas Assn. of America* v. *FERC*, 285 F.3d 18, 57-58 (D.C.

Triennial Review Order has on the costs of unbundled loops, it would be error for the Commission to set the rates without resolving the issue in this adjudicatory proceeding.

Verizon's attempt to defer scrutiny of the issue invites the same kind of "administrative law shell game" that the Court of Appeals held unlawful in *American Tel. & Tel. Co. v. FCC*, 978 F.2d 727, 731-32 (D.C. Cir. 1992), *cert. denied*, 113 S.Ct. 3020 (1993) (FCC erred in deferring an issue raised by AT&T's complaint to a future rulemaking, where the rulemaking could offer only prospective relief); *cf. Consolidated Rail Corp. v. United States*, 619 F.2d 988, 995-96 (3d Cir. 1980) (ICC erred in adjusting one element of rail car compensation formula while neglecting to resolve other, interrelated elements of formula).

Second, Verizon asserts that the Bureau's failure to consider the issue was harmless because the loop models used by the Bureau "are not based on *any* costs relating to broadband, packetized service." Verizon Opp. at 27-28. This claim is also unfounded. If broadband loops have inherently higher risk (as Verizon assumes and Paragraph 683 of the *Triennial Review Order* suggests), and those loops are unavailable for unbundling, the risk premium for the residual basic services available for unbundling should be lower. Eliminating the attribution of broadband services to telephone ratepayers should result in a lower cost of capital, and therefore lower rates, for basic services.

Moreover, the model that AT&T and WorldCom submitted did attempt to account for the relevant portion of these costs that are jointly shared by the inclusion of special access lines, and DS1 and DS3 loops, and thereby allocated certain structure costs away from switched to non-switched services. When the Bureau eliminated all non-switched loops from the input to the

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Cir. 2002); *Russe Broadcasting Co.* v. *FCC*, 87 F.3d 1456, 1463 (D.C. Cir. 1996); *International Union, United Auto., Aerospace and Agricultural Implement Workers of America* v. *Brock*, 783 F.2d 237, 246 (D.C. Cir. 1986); *National Small Shipments Traffic Conference, Inc.* v. *ICC*, 725 F.2d 1442, 1447 (D.C. Cir. 1984).

Modified Synthesis Model, it should have increased the structure sharing percentages to reflect that switched lines would also now be able to share structure with these other, unmodeled services. Structure sharing occurs not only between telecom and other networks, but between modeled and un-modeled telecom services. Increasing structure sharing assumptions would obviously reduce costs below those calculated by the Commission.

Further, the proper determination of costs attributable to the switched-only network would be the lower of the stand-alone network required to serve these lines or the costs of an integrated network less the revenues produced by non-switched services. The latter would be considerably lower than the former; hence, if Verizon is right, and the existing models do not include the costs of the non-switched lines, including those additional costs required to provide non-switched services, and deducting the associated non-switched revenues, would reduce the costs below those calculated by the FCC.

CONCLUSION

For the foregoing reasons, and those stated in AT&T's September 29 Application for Review, AT&T respectfully requests that the Commission review (and modify) the August 29 Order on the grounds discussed above.

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